RITE AID CORP
Form 4
December 24, 2014

FORM 4

OMB APPROVAL

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UNITED STATES SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

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STATEMENT OF CHANGES IN BENEFICIAL OWNERSHIP OF SECURITIES

Filed pursuant to Section 16(a) of the Securities Exchange Act of 1934, Section 17(a) of the Public Utility Holding Company Act of 1935 or Section 30(h) of the Investment Company Act of 1940

(Print or Type Responses)

1. Name and Address of Reporting Person *
STRASSLER MARC A

(Last) (First) (Middle)

30 HUNTER LANE

(Street)

CAMP HILL, PA 17011

(City) (State) (Zip)

2. Issuer Name **and** Ticker or Trading Symbol
RITE AID CORP [RAD]

3. Date of Earliest Transaction (Month/Day/Year)
12/22/2014

4. If Amendment, Date Original Filed(Month/Day/Year)

5. Relationship of Reporting Person(s) to Issuer

(Check all applicable)

_____ Director _____ 10% Owner
__X__ Officer (give title below) _____ Other (specify below)
EVP

6. Individual or Joint/Group Filing(Check Applicable Line)
_X_ Form filed by One Reporting Person
___ Form filed by More than One Reporting Person

Table I - Non-Derivative Securities Acquired, Disposed of, or Beneficially Owned

1.Title of Security (Instr. 3)	2. Transaction Date (Month/Day/Year)	2A. Deemed Execution Date, if any (Month/Day/Year)	3. Transaction Code (Instr. 8)		4. Securities Acquired (A) or Disposed of (D) (Instr. 3, 4 and 5)			5. Amount of Securities Beneficially Owned Following Reported Transaction(s) (Instr. 3 and 4)	6. Ownership Form: Direct (D) or Indirect (I) (Instr. 4)	7. Nature of Indirect Beneficial Ownership (Instr. 4)
			Code	V	Amount	(A) or (D)	Price			
Common Stock	12/22/2014		M		253,900	A	$ 1.07	822,303	D	
Common Stock	12/22/2014		M		192,675	A	$ 1.24	1,015,978	D	
Common Stock	12/22/2014		M		129,400	A	$ 1.32	1,145,378	D	
Common Stock	12/22/2014		S (1)		575,975	D	$ 6.7882	569,403	D	

Reminder: Report on a separate line for each class of securities beneficially owned directly or indirectly.

Persons who respond to the collection of information contained in this form are not required to respond unless the form displays a currently valid OMB control number.

SEC 1474 (9-02)

Table II - Derivative Securities Acquired, Disposed of, or Beneficially Owned
(*e.g.*, puts, calls, warrants, options, convertible securities)

1. Title of Derivative Security (Instr. 3)	2. Conversion or Exercise Price of Derivative Security	3. Transaction Date (Month/Day/Year)	3A. Deemed Execution Date, if any (Month/Day/Year)	4. Transaction Code (Instr. 8)		5. Number of Derivative Securities Acquired (A) or Disposed of (D) (Instr. 3, 4, and 5)		6. Date Exercisable and Expiration Date (Month/Day/Year)		7. Title and A Underlying S (Instr. 3 and 4
				Code	V	(A)	(D)	Date Exercisable	Expiration Date	Title
Non-Qualified Stock Option (right to buy)	$ 1.07	12/22/2014		M			253,900	06/23/2011(2)	06/23/2020	Common Stock
Non-Qualified Stock Option (right to buy)	$ 1.24	12/22/2014		M			192,675	06/27/2012(2)	06/27/2021	Common Stock
Non-Qualified Stock Option (right to buy)	$ 1.32	12/22/2014		M			129,400	06/25/2013(2)	06/25/2022	Common Stock

Reporting Owners

Reporting Owner Name / Address	Relationships			
	Director	10% Owner	Officer	Other
STRASSLER MARC A 30 HUNTER LANE CAMP HILL, PA 17011			EVP	

Signatures

/s/ Marc Strassler	12/24/2014
**Signature of Reporting Person	Date

Explanation of Responses:

* If the form is filed by more than one reporting person, *see* Instruction 4(b)(v).

** Intentional misstatements or omissions of facts constitute Federal Criminal Violations. *See* 18 U.S.C. 1001 and 15 U.S.C. 78ff(a).

(1) The sales reported in this Form 4 were effected pursuant to a Rule 10b5-1 trading plan adopted by the reporting person on October 9, 2014.

(2) The option vests in four equal annual installments beginning one year from the date of grant.

 yle="font-family:inherit;font-size:10pt;">168,725

167,501

167,063

Accumulated deficit
(47,475
)

(26,740
)

(39,219
)
Total shareholders’ equity
121,250

140,761

127,844

Total liabilities and shareholders’ equity
$
284,641

$
299,197

$
280,917

(1) Refer to Note 1 for information about a reclassification of supplies inventory from inventories, net, to prepaid expenses and other current assets.
The accompanying notes are an integral part of these financial statements.

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KIRKLAND’S, INC.
CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS (UNAUDITED)
(in thousands, except per share data)

	13-Week Period Ended		39-Week Period Ended	
	November 3, 2018	October 28, 2017	November 3, 2018	October 28, 2017
Net sales	$154,571	$144,979	$430,924	$409,503
Cost of sales [1]	95,289	87,840	267,619	248,820
Cost of sales related to merchandise purchased from related party vendor	12,629	11,668	34,542	32,278
Cost of sales	107,918	99,508	302,161	281,098
Gross profit	46,653	45,471	128,763	128,405
Operating expenses:				
Compensation and benefits	29,621	28,072	83,490	80,556
Other operating expenses	18,783	19,427	54,067	54,501
Depreciation (exclusive of depreciation included in cost of sales) [1]	1,867	1,739	5,405	5,089
Total operating expenses	50,271	49,238	142,962	140,146
Operating loss	(3,618)	(3,767)	(14,199)	(11,741)
Interest expense	69	69	200	195
Other income	(224)	(229)	(825)	(448)
Loss before income taxes	(3,463)	(3,607)	(13,574)	(11,488)
Income tax benefit	(683)	(1,245)	(3,197)	(3,919)
Net loss	$(2,780)	$(2,362)	$(10,377)	$(7,569)
Loss per share:				
Basic	$(0.18)	$(0.15)	$(0.66)	$(0.48)
Diluted	$(0.18)	$(0.15)	$(0.66)	$(0.48)
Weighted average shares outstanding:				
Basic	15,486	16,013	15,673	15,932
Diluted	15,486	16,013	15,673	15,932

[1] Refer to Note 1 for information about a reclassification of supply-chain and store-related depreciation expense to cost of sales.

The accompanying notes are an integral part of these financial statements.

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KIRKLAND'S, INC.
CONDENSED CONSOLIDATED STATEMENT OF SHAREHOLDERS' EQUITY (UNAUDITED)
(in thousands, except share data)

	Common Stock		Accumulated Deficit	Total Shareholders' Equity
	Shares	Amount		
Balance at February 3, 2018	15,977,239	$167,501	$ (26,740)	$ 140,761
Employee stock purchases	28,246	238	—	238
Exercise of stock options	177,526	23	—	23
Restricted stock issued	108,900	—	—	—
Net share settlement of stock options and restricted stock	(146,355)	(378)	—	(378)
Stock-based compensation expense	—	1,341	—	1,341
Repurchase and retirement of common stock	(1,082,117)	—	(10,358)	(10,358)
Net loss	—	—	(10,377)	(10,377)
Balance at November 3, 2018	15,063,439	$168,725	$ (47,475)	$ 121,250

The accompanying notes are an integral part of these financial statements.

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KIRKLAND'S, INC.
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS (UNAUDITED)
(in thousands)

	39-Week Period Ended	
	November 3, 2018	October 28, 2017
Cash flows from operating activities:		
Net loss	$(10,377)	$(7,569)
Adjustments to reconcile net loss to net cash used in operating activities:		
Depreciation of property and equipment	21,992	19,841
Amortization of deferred rent	(6,826)	(5,784)
Amortization of debt issue costs	41	40
Loss on disposal of property and equipment	340	157
Stock-based compensation expense	1,341	1,766
Deferred income taxes	988	2,312
Changes in assets and liabilities:		
Inventories, net [(1)]	(32,504)	(31,550)
Prepaid expenses and other current assets [(1)]	(2,318)	(2,396)
Other noncurrent assets	(699)	(1,554)
Accounts payable	9,856	10,502
Accounts payable to related party vendor	3,738	2,663
Income taxes refundable	(9,951)	(13,609)
Accrued expenses and other current and noncurrent liabilities	3,560	12,912
Net cash used in operating activities	(20,819)	(12,269)
Cash flows from investing activities:		
Capital expenditures	(25,025)	(23,617)
Net cash used in investing activities	(25,025)	(23,617)
Cash flows from financing activities:		
Cash used in net share settlement of stock options and restricted stock	(378)	(201)
Proceeds received from employee stock option exercises	23	—
Employee stock purchases	238	253
Repurchase and retirement of common stock	(10,358)	(218)
Net cash used in financing activities	(10,475)	(166)
Cash and cash equivalents:		
Net decrease	(56,319)	(36,052)
Beginning of the period	80,156	63,937
End of the period	$23,837	$27,885
Supplemental schedule of non-cash activities:		
Non-cash accruals for purchases of property and equipment	$1,970	$1,997

[1] Refer to Note 1 for information about a reclassification of supplies inventory from inventories, net, to prepaid expenses and other current assets.

The accompanying notes are an integral part of these financial statements.

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KIRKLAND'S, INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

Note 1 - Description of Business and Basis of Presentation

Kirkland's, Inc. (the "Company") is a specialty retailer of home décor in the United States operating 432 stores in 37 states as of November 3, 2018, as well as an e-commerce enabled website, www.kirklands.com. The condensed consolidated financial statements of the Company include the accounts of Kirkland's, Inc. and its wholly-owned subsidiaries, Kirkland's Stores, Inc., Kirkland's DC, Inc., and Kirkland's Texas, LLC. Significant intercompany accounts and transactions have been eliminated.

The accompanying unaudited condensed consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States for interim financial information and are presented in accordance with the requirements of Form 10-Q and Article 10 of Regulation S-X. Accordingly, they do not include all of the information and notes required for complete financial statements. In the opinion of management, all adjustments, including normal recurring accruals, considered necessary for a fair presentation have been included. These financial statements should be read in conjunction with the audited financial statements included in the Company's Annual Report on Form 10-K filed with the Securities and Exchange Commission on April 3, 2018.

It should be understood that accounting measurements at interim dates inherently involve greater reliance on estimates than those at fiscal year-end. In addition, because of seasonality factors, the results of the Company's operations for the 13-week and 39-week periods ended November 3, 2018 are not indicative of the results to be expected for any other interim period or for the entire fiscal year. The Company's fiscal year ends on the Saturday closest to January 31, resulting in years of either 52 or 53 weeks.

The preparation of the condensed consolidated financial statements in conformity with accounting principles generally accepted in the United States requires management to make estimates and assumptions that affect the amounts reported in the condensed consolidated financial statements and accompanying notes. Actual results could differ from the estimates and assumptions used.

Changes in estimates are recognized in the period when new information becomes available to management. Areas where the nature of the estimate makes it reasonably possible that actual results could materially differ from amounts estimated include, but are not limited to, impairment assessments on long-lived assets, asset retirement obligations, inventory reserves, self-insurance reserves, income tax liabilities, stock-based compensation, employee bonus accruals, gift card breakage and contingent liabilities.

In the fourth quarter of fiscal 2017, the Company concluded that it was appropriate to classify supplies inventory in prepaid expenses and other current assets instead of inventories, net, in the consolidated financial statements. The Company reclassified prior period amounts to reflect this change. This resulted in $2.6 million reclassified from inventories, net, to prepaid expenses and other current assets on the condensed consolidated balance sheet as of October 28, 2017, and $0.3 million reclassified from inventories, net, to prepaid expense and other current assets in the changes in assets and liabilities section of the condensed consolidated statements of cash flows for the 39-week period ended October 28, 2017.

Also, during the fourth quarter of fiscal 2017, the Company reclassified supply chain and store-related depreciation expense to cost of sales whereas it was previously included in depreciation in its financial statements. The Company also reclassified prior period amounts to reflect this change. This reclassification increased cost of sales by approximately $5.1 million and $14.8 million for the 13-week and 39-week periods ended October 28, 2017, respectively, with an equal and offsetting decrease to depreciation. This reclassification had no impact on net sales, operating loss, net loss or loss per share.

For the 13-week and 39-week periods ended November 3, 2018, the Company recorded an unfavorable $0.7 million one-time out-of-period adjustment related to revised straight-line rent calculations to cost of sales from deferred rent. For the 39-week period ended October 28, 2017, the Company recorded a favorable $1.2 million one-time out-of-period adjustment of ancillary rent payments to prepaid expenses and other current assets from cost of sales.

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Note 2 - Income Taxes

An estimate of the annual effective tax rate is used at each interim period based on the facts and circumstances available at that time, while the actual effective tax rate is calculated at year-end. For the 13-week periods ended November 3, 2018 and October 28, 2017, the Company recorded an income tax benefit of 19.7% and 34.5% of the loss before income taxes, respectively. For the 39-week periods ended November 3, 2018 and October 28, 2017, the Company recorded an income tax benefit of 23.6% and 34.1% of the loss before income taxes, respectively. The decrease in the tax rate for the 13-week and 39-week periods ended November 3, 2018 was primarily due to the effect of the U.S. Tax Cuts and Jobs Act, which reduced the U.S. federal corporate rate from 35% to 21% effective as of January 1, 2018, which was partially offset by additional tax expense related to stock compensation activity.

Note 3 - Loss Per Share

Basic loss per share is computed by dividing net loss by the weighted average number of shares outstanding during each period presented. Diluted loss per share is computed by dividing net loss by the weighted average number of shares outstanding plus the dilutive effect of stock equivalents outstanding during the applicable periods using the treasury stock method. Diluted loss per share reflects the potential dilution that could occur if options to purchase stock were exercised into common stock and if outstanding grants of restricted stock were vested. Stock options and restricted stock units that were not included in the computation of diluted loss per share, because to do so would have been antidilutive, were approximately 1.2 million and 1.6 million shares for each of the 13-week periods ended November 3, 2018 and October 28, 2017, respectively, and 1.3 million and 1.5 million shares for each of the 39-week periods ended November 3, 2018 and October 28, 2017, respectively.

Note 4 - Fair Value of Financial Instruments

Fair value is defined as the price that would be received to sell an asset or paid to transfer a liability (an exit price) in an orderly transaction between market participants on the measurement date. The Company uses a three-tier fair value hierarchy, which prioritizes the inputs used in measuring fair value. These tiers include: Level 1, defined as observable inputs such as quoted prices in active markets; Level 2, defined as inputs other than quoted prices in active markets that are either directly or indirectly observable; and Level 3, defined as unobservable inputs in which little or no market data exists, therefore requiring an entity to develop its own assumptions. The carrying amounts of cash and cash equivalents, accounts receivable, other current assets and accounts payable approximate fair value because of their short maturities. The Company also maintains The Executive Non-Qualified Excess Plan (the "Deferred Compensation Plan"). The Deferred Compensation Plan is funded, and the Company invests participant deferrals into trust assets, which are invested in a variety of mutual funds that are Level 1 inputs. The plan assets and plan liabilities are adjusted to fair value on a recurring basis. Deferred Compensation Plan assets and liabilities were approximately $2.1 million, $2.2 million, and $2.2 million as of November 3, 2018, February 3, 2018, and October 28, 2017, respectively, and were recorded in other assets and other liabilities in the condensed consolidated balance sheets.

Note 5 - Commitments and Contingencies

The Company was named as a defendant in a putative class action filed in April 2017 in the United States District Court for the Western District of Pennsylvania, Gennock v. Kirkland's, Inc. The complaint alleges that the Company, in violation of federal law, published more than the last five digits of a credit or debit card number on customers' receipts. The Company denies the material allegations of the complaint. On January 9, 2018, the District Court denied the Company's motion to dismiss this matter. On January 31, 2018, the Court granted the Company's motion to stay the proceedings in its case pending the Third Circuit's decision in Kamal v. J. Crew Group, Inc., No. 17-2345 (3d. Cir.).

The J. Crew case presents the exact same standing issues as the Company’s case, but in J. Crew the defendant was granted its motion to dismiss at the trial court level. On appeal, the Third Circuit heard oral argument in the J. Crew case on February 8, 2018, and a decision is expected this year. The Company continues to believe that the case is without merit and intends to continue to vigorously defend itself against the allegations. The matter is covered by insurance, and the Company does not believe that the case will have a material adverse effect on its consolidated financial condition, operating results or cash flows.

The Company has been named as a defendant in a putative class action filed in May 2018 in the Superior Court of California, Miles v. Kirkland’s Stores, Inc. The case has been removed to Federal Court, Central District of California, and trial is not yet set. The complaint alleges, on behalf of Miles and all other hourly Kirkland’s employees in California, various wage and hour violations. Kirkland’s denies the material allegations in the complaint and believes that its employment policies are generally compliant with California law. The parties have tentatively agreed to an early mediation with minimal exchange of discovery. To date, the parties have exchanged the court mandated initial disclosures, and the Court has issued a notice of intent to issue a scheduling order on January 10, 2019. The Company believes the case is without merit and intends to vigorously defend itself against the allegations.

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The Company is also party to other pending legal proceedings and claims that arise in the normal course of business. Although the outcome of such proceedings and claims cannot be determined with certainty, the Company's management is of the opinion that it is unlikely that such proceedings and any claims in excess of insurance coverage will have a material effect on the Company's consolidated financial condition, operating results or cash flows.

Note 6 - Stock-Based Compensation

The Company maintains equity incentive plans under which it may grant non-qualified stock options, incentive stock options, restricted stock, restricted stock units, or stock appreciation rights to employees, non-employee directors and consultants. Compensation expense is recognized on a straight-line basis over the vesting periods of each grant. There have been no material changes in the assumptions used to compute compensation expense during the current quarter. The table below sets forth selected stock-based compensation information (in thousands, except share amounts) for the periods indicated:

	13-Week Period Ended		39-Week Period Ended	
	November 3, 2018	October 28, 2017	November 3, 2018	October 28, 2017
Stock-based compensation expense (included in compensation and benefits on the condensed consolidated statements of operations)	$450	$ 582	$ 1,341	$ 1,766
Stock options granted	—	—	157,700	245,000
Restricted stock units granted	132,834	2,000	243,734	148,500

Note 7 - Related Party Transactions

The Company has an agreement with a related party vendor to purchase merchandise inventory. The vendor is considered a related party for financial reporting purposes because its principal owner is the spouse of the Company's Vice President of Merchandising. The table below sets forth selected results related to this vendor in dollars (in thousands) and percentages for the periods indicated:

	13-Week Period Ended		39-Week Period Ended	
	November 3, 2018	October 28, 2017	November 3, 2018	October 28, 2017
Related Party Vendor:				
Purchases	$ 17,444	$ 17,684	$ 41,966	$ 41,743
Purchases as a percent of total merchandise purchases	22.5 %	20.4 %	21.1 %	21.5 %

Note 8 - Stock Repurchase Plan

On August 22, 2017, the Company announced that its Board of Directors authorized a stock repurchase plan providing for the purchase in the aggregate of up to $10 million of the Company's outstanding common stock. This stock repurchase plan was completed during the third quarter of fiscal 2018. On September 24, 2018, the Company announced that its Board of Directors authorized a new stock repurchase plan providing for the purchase in the aggregate of up to $10 million of the Company's outstanding common stock. Repurchases of shares will be made in accordance with applicable securities laws and may be made from time to time in the open market or by negotiated transactions. The amount and timing of repurchases will be based on a variety of factors, including stock acquisition price, regulatory limitations and other market and economic factors. The stock repurchase plan does not require the

Company to repurchase any specific number of shares, and the Company may terminate the repurchase plan at any time. The table below sets forth selected stock repurchase plan information (in thousands, except share amounts) for the periods indicated:

	13-Week Period Ended		39-Week Period Ended	
	November 3, 2018	October 28, 2017	November 3, 2018	October 28, 2017
Shares repurchased and retired	689,473	18,901	1,082,117	18,901
Share repurchase cost	$6,554	$ 218	$10,358	$ 218

As of November 3, 2018, the Company had approximately $9.0 million remaining under the new stock repurchase plan.

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Note 9 - New Accounting Pronouncements

New Accounting Pronouncements Recently Adopted

In May 2014, the Financial Accounting Standards Board (the "FASB") issued Accounting Standards Update ("ASU") 2014-09, "Revenue from Contracts with Customers (Topic 606)" ("ASU 2014-09"). Under ASU 2014-09, an entity will recognize revenue when it transfers promised goods or services to customers in an amount that reflects what it expects in exchange for the goods or services. ASU 2014-09 also requires more detailed disclosures to enable users of financial statements to understand the nature, amount, timing, and uncertainty of revenue and cash flows arising from contracts with customers. The amendments in ASU 2014-09 were effective for the Company at the beginning of its fiscal 2018 year. Companies that transitioned to this new standard could either retrospectively restate each prior reporting period or reflect the cumulative effect of initially applying the updates with an adjustment to retained earnings at the date of adoption. The Company adopted this standard in the first quarter of fiscal 2018 using the modified retrospective method. The Company identified its loyalty program as the area that was most affected by the new revenue recognition guidance. Additionally, the Company's historical accounting for gift card breakage is consistent with the new revenue recognition guidance. The Company's gift card liability, net of estimated breakage, was $10.3 million, $11.3 million and $8.5 million as of November 3, 2018, February 3, 2018 and October 28, 2017, respectively, which is included in accrued expenses on the condensed consolidated balance sheet. During the 13-week period ended November 3, 2018, the Company recognized $1.8 million of gift card redemptions related to amounts included in the gift card contract liability balance of $10.4 million as of August 4, 2018. During the 39-week period ended November 3, 2018, the Company recognized $5.0 million of gift card redemptions related to amounts included in the gift card contract liability balance of $11.3 million as of February 3, 2018. The adoption of this guidance did not have a material impact on the Company's condensed consolidated financial statements and related disclosures.

In May 2017, the FASB issued ASU 2017-09, "Compensation - Stock Compensation (Topic 718): Scope of Modification Accounting" ("ASU 2017-09"). This update provides guidance about which changes to the terms or conditions of a share-based payment award require an entity to apply modification accounting in Topic 718. An entity should account for the effects of a modification unless (a) the fair value of the modified award is the same as the fair value of the original award immediately before the original award is modified, (b) the vesting conditions of the modified award are the same as the vesting conditions of the original award immediately before the original award is modified and (c) the classification of the modified award as an equity instrument or a liability instrument is the same as the classification of the original award immediately before the original award is modified. The amendments in ASU 2017-09 are effective for public business entities for annual periods beginning after December 15, 2017, including interim periods within those annual periods. Early adoption is permitted, including adoption in any interim period, for public business entities for reporting periods for which financial statements have not been issued. The amendments in ASU 2017-09 should be applied prospectively to an award modified on or after the adoption date. The Company adopted this guidance in the first quarter of fiscal 2018. The adoption of this guidance did not have a material impact on the Company's condensed consolidated financial statements and related disclosures.

New Accounting Pronouncements Not Yet Adopted

In February 2016, the FASB issued ASU 2016-02, "Leases (Topic 842)", which supersedes the existing guidance for lease accounting, Leases (Topic 840) ("ASU 2016-02"). ASU 2016-02 requires lessees to recognize a lease liability and a right-of-use asset for all leases. Lessor accounting remains largely unchanged. In July 2018, the FASB issued ASU 2018-11, "Leases (Topic 842): Targeted Improvements," which provides an optional transition method in addition to the existing modified retrospective transition method by allowing a cumulative effect adjustment to the opening balance of retained earnings in the period of adoption. Under this transition method, companies may continue to report comparative periods under ASC 840, although they must also provide the required disclosures under ASC 840 for all periods presented under ASC 840. These new leasing standards are effective for fiscal years beginning after December 15, 2018 and interim periods within those fiscal years. Early adoption is permitted for all entities. The Company intends to adopt this guidance in the first quarter of fiscal 2019 using the optional transition method provided by ASU 2018-11. The Company is currently evaluating the impact of this new standard on its condensed consolidated financial statements and is anticipating a material impact on the Company's consolidated financial statements because the Company is party to a significant number of lease contracts.

Note 10 - Senior Credit Facility

The Company is party to a Joinder and First Amendment to Amended and Restated Credit Agreement (the "Credit Agreement") with Bank of America, N.A. as administrative agent and collateral agent, and the lenders named therein (the "Lenders"). The Credit Agreement includes a senior secured revolving credit facility of $75 million, a swingline availability of $10 million, a $25 million incremental accordion feature and a maturity date of February 2021. Borrowings under the Credit Agreement bear interest at an annual rate equal to LIBOR plus a margin ranging from 125 to 175 basis points with no LIBOR floor, and the fee paid to the Lenders on the unused portion of the credit facility is 25 basis points per annum.

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Borrowings under the Credit Agreement are subject to certain conditions and contain customary events of default, including, without limitation, failure to make payments, a cross-default to certain other debt, breaches of covenants, breaches of representations and warranties, a change in control, certain monetary judgments and bankruptcy and ERISA events. Upon any such event of default, the principal amount of any unpaid loans and all other obligations under the Credit Agreement may be declared immediately due and payable. The maximum availability under the facility is limited by a borrowing base formula which consists of a percentage of eligible inventory and eligible credit card receivables, less reserves.

The Company is subject to an Amended and Restated Security Agreement (the "Security Agreement") with its Lenders. Pursuant to the Security Agreement, the Company pledged and granted to the administrative agent, for the benefit of itself and the secured parties specified therein, a lien on and security interest in all of the rights, title and interest in substantially all of the Company's assets to secure the payment and performance of the obligations under the Credit Agreement.

As of November 3, 2018, the Company was in compliance with the covenants in the Credit Agreement, and there were no outstanding borrowings under the credit facility, with approximately $75.0 million available for borrowing.

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ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

Forward-Looking Statements

This Management's Discussion and Analysis of Financial Condition and Results of Operations ("MD&A") is intended to provide an understanding of our financial condition, change in financial condition, cash flow, liquidity and results of operations. The following MD&A discussion should be read in conjunction with the condensed consolidated financial statements and notes to those statements that appear elsewhere in this Quarterly Report on Form 10-Q and in our Annual Report on Form 10-K for the fiscal year ended February 3, 2018, filed with the Securities and Exchange Commission on April 3, 2018 (the "Annual Report"). The following discussion contains forward-looking statements that reflect our plans, estimates and beliefs. Our actual results could differ materially from those discussed or referred to in the forward-looking statements. Factors that could cause or contribute to any differences include, but are not limited to, those discussed under the caption "Cautionary Statement for Purposes of the "Safe Harbor" Provisions of the Private Securities Litigation Reform Act of 1995" and under Part II, Item 1A - "Risk Factors".

General

We are a specialty retailer of home décor in the United States, operating 432 stores in 37 states as of November 3, 2018, as well as an e-commerce enabled website, www.kirklands.com. Our stores present a broad selection of distinctive merchandise, including holiday décor, framed art, furniture, ornamental wall décor, fragrance and accessories, mirrors, lamps, decorative accessories, textiles, housewares, gifts, artificial floral products, frames, clocks and outdoor living items. Our stores offer an extensive assortment of holiday merchandise during seasonal periods as well as items carried throughout the year suitable for gift-giving. We provide our customers an engaging shopping experience characterized by a diverse, ever-changing merchandise selection reflecting current styles at prices which provide discernible value. This combination of ever-changing and stylish merchandise, value pricing and a stimulating online and store experience has led to our emergence as a leader in home décor and enabled us to develop a strong customer base.

Overview of Key Financial Measures

Net sales and gross profit are the most significant drivers of our operating performance. Net sales consists of all merchandise sales to customers, gift card breakage revenue and shipping revenue associated with e-commerce sales, net of returns and excluding sales taxes. We use comparable store sales to measure our ability to achieve sales increases from stores that have been open for at least 13 full fiscal months. Stores closed during the year are included in the comparable store sales calculation only for the full fiscal months of the year the stores were open. Relocated stores are removed from the comparable store base when the existing store closes, and the new replacement store is added into the comparable store sales calculation after 13 full fiscal months of activity. The e-commerce store sales, including shipping revenue, are included in comparable store sales. Increases in comparable store sales are an important factor in maintaining or increasing the profitability of existing stores.

Gross profit is the difference between net sales and cost of sales. Cost of sales has various distinct components including: product cost of sales (including inbound freight, damages and inventory shrinkage), store occupancy costs (including rent and depreciation of leasehold improvements and other property and equipment), outbound freight costs (including e-commerce shipping) and central distribution costs (including operational costs and depreciation of leasehold improvements and other property and equipment). Product and outbound freight costs are variable, while occupancy and central distribution costs are largely fixed. Accordingly, gross profit expressed as a percentage of net sales can be influenced by many factors including overall sales performance.

Store Growth

The following table summarizes our store openings and closings during the periods indicated:

	13-Week Period Ended		39-Week Period Ended	
	November 3, 2018	October 28, 2017	November 3, 2018	October 28, 2017
New stores opened during the period	6	10	22	26
Stores closed during the period	—	1	8	15

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The following table summarizes our stores and square footage under lease:

	November 3, 2018	October 28, 2017
Number of stores	432	415
Square footage	3,420,097	3,275,638
Average square footage per store	7,917	7,893

13-Week Period Ended November 3, 2018 Compared to the 13-Week Period Ended October 28, 2017

Results of operations. The table below sets forth selected results of our operations both in dollars (in thousands) and as a percentage of net sales for the periods indicated:

	13-Week Period Ended					
	November 3, 2018		October 28, 2017		Change	
	$	%	$	%	$	%
Net sales	$154,571	100.0 %	$144,979	100.0 %	$9,592	6.6 %
Cost of sales	107,918	69.8	99,508	68.6	8,410	8.5
Gross profit	46,653	30.2	45,471	31.4	1,182	2.6
Operating expenses:						
Compensation and benefits	29,621	19.2	28,072	19.4	1,549	5.5
Other operating expenses	18,783	12.1	19,427	13.4	(644)	(3.3)
Depreciation (exclusive of depreciation included in cost of sales)	1,867	1.2	1,739	1.2	128	7.4
Total operating expenses	50,271	32.5	49,238	34.0	1,033	2.1
Operating loss	(3,618)	(2.3)	(3,767)	(2.6)	149	(4.0)
Interest expense	69	—	69	—	—	—
Other income	(224)	(0.1)	(229)	(0.1)	5	(2.2)
Loss before income taxes	(3,463)	(2.2)	(3,607)	(2.5)	144	(4.0)
Income tax benefit	(683)	(0.4)	(1,245)	(0.9)	562	(45.1)
Net loss	$(2,780)	(1.8)%	$(2,362)	(1.6)%	$(418)	17.7 %

Net sales. Net sales increased 6.6% to $154.6 million for the third quarter of fiscal 2018 compared to $145.0 million for the prior-year period. The impact of net new store growth contributed an increase in net sales of $7.6 million. This was in addition to an increase in comparable store sales, including e-commerce sales, of 1.4%, or $2.0 million for the third quarter of fiscal 2018 compared to the prior-year period. Comparable store sales, including e-commerce sales, increased 0.7% in the prior-year period. For the third quarter of fiscal 2018, e-commerce comparable sales increased 22.9% versus the prior-year period, while comparable store sales at brick-and-mortar stores decreased 1.2% versus the prior-year period. For brick-and-mortar stores, the comparable store sales decrease was primarily due to a decrease in transactions partially offset by an increase in average ticket. The decreased transactions resulted from a decline in traffic partially offset by an increase in conversion. The increase in average ticket resulted from an increase in average retail price. For e-commerce, comparable sales benefited from an increase in transactions due to higher website traffic, while average ticket decreased slightly, driven primarily by a decrease in items per transaction coupled with a slight decrease in average retail price. The merchandise categories contributing most to the comparable store sales increase for the third quarter of fiscal 2018 were holiday, fragrance and accessories, textiles, and floral, which were partially offset by decreases in art, mirrors and lamps.

Gross profit. Gross profit as a percentage of net sales decreased 120 basis points from 31.4% in the third quarter of fiscal 2017 to 30.2% in the third quarter of fiscal 2018. The overall decrease in gross profit margin was due to higher store occupancy and depreciation expenses, lower merchandise margin, and higher outbound freight expense, partially offset by lower distribution center expenses. Store occupancy and depreciation costs increased approximately 80 basis points as a percentage of net sales, primarily due to an unfavorable $0.7 million one-time out-of-period adjustment to deferred rent in the current period, in addition to sales deleverage. Merchandise margin decreased approximately 30 basis points from 55.7% in the third quarter of fiscal 2017 to 55.4% in the third quarter of fiscal 2018 due to higher inbound freight costs driven by rate pressure and slightly lower product margin driven by increased promotional activity, partially offset by lower shrink costs. Outbound freight costs, which include e-commerce shipping, increased approximately 20 basis points as a percentage of net sales, which was driven by an increase in e-

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commerce shipping costs due to the further expansion of this channel. Central distribution costs, including depreciation, decreased 10 basis points as a percentage of net sales.

Compensation and benefits. Compensation and benefits as a percentage of net sales decreased approximately 20 basis points from 19.4% in the third quarter of fiscal 2017 to 19.2% in the third quarter of fiscal 2018 as a result of lower corporate and store payroll and employee benefit expenses, partially offset by charges associated with the transition of our Chief Executive Officers.

Other operating expenses. Other operating expenses as a percentage of net sales decreased approximately 130 basis points from 13.4% in the third quarter of fiscal 2017 to 12.1% in the third fiscal quarter of 2018. The decrease as a percentage of net sales was primarily due to cost control initiatives and favorable self-insured workers' compensation and general liability claims trends.

Income tax benefit. We recorded an income tax benefit of approximately $0.7 million, or 19.7% of the loss before income taxes during the third quarter of fiscal 2018, compared to an income tax benefit of approximately $1.2 million, or 34.5% of the loss before income taxes during the prior-year quarter. The decrease in the tax rate for the third quarter of fiscal 2018 compared to the prior-year quarter was primarily due to the effect of the U.S. Tax Cuts and Jobs Act, which reduced the U.S. federal corporate rate from 35% to 21% effective as of January 1, 2018, which was partially offset by additional tax expense related to stock compensation activity.

Net loss and loss per share. We reported a net loss of $2.8 million, or $0.18 per diluted share, for the third quarter of fiscal 2018 as compared to a net loss of $2.4 million, or $0.15 per diluted share, for the third quarter of fiscal 2017. Included in the reported net loss for the third quarter of fiscal 2018 are severance and other charges of approximately $755,000, net of tax, associated with the transition of our Chief Executive Officers. These charges increased the net loss for the third quarter of fiscal 2018 by approximately $0.05 per diluted share.

39-Week Period Ended November 3, 2018 Compared to the 39-Week Period Ended October 28, 2017

Results of operations. The table below sets forth selected results of our operations both in dollars (in thousands) and as a percentage of net sales for the periods indicated:

	39-Week Period Ended					
	November 3, 2018		October 28, 2017		Change	
	$	%	$	%	$	%
Net sales	$430,924	100.0 %	$409,503	100.0 %	$21,421	5.2 %
Cost of sales	302,161	70.1	281,098	68.6	21,063	7.5
Gross profit	128,763	29.9	128,405	31.4	358	0.3
Operating expenses:						
Compensation and benefits	83,490	19.4	80,556	19.7	2,934	3.6
Other operating expenses	54,067	12.5	54,501	13.3	(434)	(0.8)
Depreciation (exclusive of depreciation included in cost of sales)	5,405	1.3	5,089	1.3	316	6.2
Total operating expenses	142,962	33.2	140,146	34.3	2,816	2.0
Operating loss	(14,199)	(3.3)	(11,741)	(2.9)	(2,458)	20.9
Interest expense	200	—	195	—	5	2.6
Other income	(825)	(0.2)	(448)	(0.1)	(377)	84.2
Loss before income taxes	(13,574)	(3.1)	(11,488)	(2.8)	(2,086)	18.2
Income tax benefit	(3,197)	(0.7)	(3,919)	(1.0)	722	(18.4)

Net loss	$(10,377)	(2.4)%	$(7,569)	(1.8)%	$(2,808)